

## Internal Revenue Service

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### LEGEND

A =

B =

X =

Y =

Z =

Old P =

New P =

Date 1 =

Date 2 =

Date 3 =

Date 4 =

Date 5 =

Date 6 =

Date 7 =

State =

Dear :

This responds to a letter dated April 21, 2016, submitted on behalf of Z (successor to X and Y) by Z's authorized representative, requesting relief under section 1362(f) of the Internal Revenue Code (the Code).

#### FACTS

According to the information submitted and representations made, X was incorporated on Date 1 under the laws of State, a community property state. Effective Date 2, X made an election to be treated as an S corporation. On Date 3, X converted to Y, a limited partnership under the laws of State, and made an election to be treated as an association taxable as a corporation for U.S. federal income tax purposes effective as of Date 3. On Date 7, Y converted to Z, a State corporation, under the laws of State. X, Y, and Z are hereinafter collectively referred to as the taxpayer.

Immediately prior to Date 3, A was the sole shareholder of X. On Date 3, A transferred a portion of A's interest in Y to Old P in exchange for all the interests of Old P. The taxpayer represents that A and A's spouse treated Old P as a partnership for U.S. federal income tax purposes. In connection with this transaction, A and Old P entered into a partnership agreement that provided that liquidating distributions would be made to all partners pro rata in accordance with their respective capital account balances, as adjusted, up to the amounts of those capital accounts, and thereafter to all partners pro rata according to their respective percentage interests in the partnership (the "Liquidation Provision"). On Date 4, A's spouse and B each acquired limited partnership interests in Y. On Date 5, B transferred all of B's interests in Y equally to A and A's spouse. On Date 6, A caused New P to replace Old P as an owner of Y. The taxpayer represents that New P is an entity that is disregarded for U.S. federal income tax purposes and that all of the interests in New P are owned by A and A's spouse.

Y's S election terminated on Date 3 when Old P, an impermissible shareholder, acquired interests in Y. The conversion on Date 3, or the issuance of limited partnership interests on Date 4, also may have created a second class of stock in violation of the one class of stock requirement under § 1361(b)(1)(D), thereby possibly

causing Y's S corporation election to terminate. Other than this termination and these potential terminations of the S corporation election, the taxpayer represents that it has qualified as an S corporation. The taxpayer represents that the conversions on Date 3 and Date 7 qualified as F reorganizations within the meaning of § 368(a)(1)(F). The taxpayer represents that it believed that the S corporation election succeeded to Y and Z because the conversions were F reorganizations.

The taxpayer represents that the possible termination of its S corporation election was inadvertent and was not motivated by tax avoidance or retroactive tax planning. The taxpayer represents that neither it nor any of its shareholders intended to terminate the taxpayer's Subchapter S election. In addition, the taxpayer represents that the taxpayer's S corporation election has not been terminated by revocation, and that Z has not at any time had sufficient passive investment income to cause a termination of the S corporation election under § 1362(d)(3). Further, the taxpayer represents that the taxpayer and its shareholders agree to make any adjustments required as a condition of obtaining relief under the inadvertent termination rule as provided under § 1362(f) of the Code that may be required by the Secretary. The taxpayer and its shareholders represent that they have filed all returns consistent with the taxpayer being an S corporation.

#### LAW AND ANALYSIS

Section 1361(a)(1) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for the year. Section 1361(b)(1) defines a "small business corporation" as a domestic corporation which is not an ineligible corporation and which does not (A) have more than 100 shareholders, (B) have as a shareholder a person (other than an estate, a trust described in § 1361(c)(2), or an organization described in § 1361 (c)(6)) who is not an individual, (C) have a nonresident alien as a shareholder, and (D) have more than 1 class of stock.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the 1st day of the taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Rev. Proc. 99-51, 1999-52 I.R.B. 760, provides that a general partnership interest includes rights and obligations not included in a limited partnership interest. If these obligations and rights result in general and limited partnership interests in a limited partnership having non-pro rata distribution rights, such interests are different classes of stock for purposes of § 1361(b)(1)(D).

Rev. Proc. 2002-69, 2002-2 C.B. 831, provides that, if a qualified entity, and a husband and wife, as community property owners of the entity, treat the entity as either a

disregarded entity or a partnership for federal tax purposes, the Service will accept the selected treatment for federal tax purposes. A business entity is a qualified entity if (1) the business entity is wholly-owned by a husband and wife as community property under the laws of a state, (2) no person other than one or both spouses would be considered an owner for federal tax purposes, and (3) the business entity is not treated as a corporation under § 301.7701-2 of the Procedure and Administration Regulations.

Section 1362(f) provides in part that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d), (2) the Secretary determines that the circumstances resulting in the termination were inadvertent, (3) no later than a reasonable period of time after the discovery of the circumstances resulting in the termination, steps were taken so that the corporation for which the termination occurred is a small business corporation, and (4) the corporation for which the termination occurred, and each person who was a shareholder in such corporation at any time during the period of inadvertent termination of the S election, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation is treated as an S corporation during the period specified by the Secretary.

## CONCLUSION

Based solely on the facts submitted and the representations made, we conclude that Y's S election terminated on Date 3 when Old P, an impermissible shareholder, acquired interests in Y. We further conclude that, if Y's S election had not terminated on Date 3 because an impermissible shareholder acquired shares, the conversion on Date 3 or the issuance of limited partnership interests on Date 4 may have caused the taxpayer to have more than one class of stock, as a result of Y being a limited partnership or having the Liquidation Provision. We conclude, however, that the termination and potential terminations described above were inadvertent within the meaning of § 1362(f). Therefore, the taxpayer will be treated as an S corporation effective Date 3, provided the taxpayer's S corporation election is not terminated under § 1362(d), other than those terminations described in this letter.

Except as specifically ruled upon above, we express or imply no opinion concerning the federal tax consequences of the facts of this case under any other provision of the Code. Specifically, we express or imply no opinion regarding the taxpayer's eligibility to be an S corporation. In addition, we express or imply no opinion on whether the conversions on Date 3 and Date 7 qualified as F reorganizations within the meaning of § 368(a)(1)(F).

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to the taxpayer's authorized representative.

Sincerely,

Joy C. Spies

Joy C. Spies

Senior Technician Reviewer, Branch 1

Office of the Associate Chief Counsel

(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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